



**UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION**

)	
IN THE MATTER OF)	
)	
Morgan Stanley Smith Barney LLC,)	CFTC Docket No. - <u>14-11</u>
)	
Respondent.)	
)	

**ORDER INSTITUTING PROCEEDINGS PURSUANT TO SECTIONS 6(c) AND 6(d) OF
THE COMMODITY EXCHANGE ACT AND MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Commodity Futures Trading Commission (“Commission”) has reason to believe that Morgan Stanley Smith Barney LLC (“MSSB”), a registered futures commission merchant (“FCM”), has violated Section 4d(a)(2) of the Commodity Exchange Act (“Act”), 7 U.S.C. § 6d(a)(2) (2012), and Commission Regulations (“Regulations”) 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3, 17 C.F.R. §§ 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3 (2013). Therefore, the Commission deems it appropriate and in the public interest that a public administrative proceeding be, and hereby is, instituted to determine whether MSSB engaged in the violations as set forth herein and to determine whether any order shall be issued imposing remedial sanctions.

II.

In anticipation of the institution of this administrative proceeding, MSSB has submitted an Offer of Settlement (“Offer”), which the Commission has determined to accept. Without admitting or denying any of the findings or conclusions herein, MSSB consents to the entry of and acknowledges service of this Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act and Making Findings and Imposing Remedial Sanctions (“Order”) and acknowledges service of this Order.¹

¹ MSSB consents to the entry of this Order and the use of these findings in this proceeding and in any other proceeding brought by the Commission or to which the Commission is a party; provided, however, that MSSB does not consent to the use of the Offer, or the findings or conclusions consented to in this Order, as the sole basis for any other proceeding brought by the Commission, other than in a proceeding in bankruptcy or to enforce the terms of this Order. Nor does MSSB consent to the use of the Offer or this Order, or the findings or conclusions consented to in the Offer or this Order, by any other party in any other proceeding.

III.

The Commission finds the following:

A. Summary

At various times between at least May 2012 and April 2013, MSSB committed violations of the Act and Regulations that related to MSSB's procedures for handling segregated and secured accounts. None of the violations resulted in customer losses; nevertheless, the violations demonstrate a lack of adequate internal controls and a failure to diligently supervise the handling of matters related to MSSB's business as a Commission registrant.

B. Respondent

Morgan Stanley Smith Barney LLC is an FCM located at 2000 Westchester Place, Purchase, New York 10577. MSSB has been continuously registered with the Commission since May 2009. It possesses approximately \$4 billion in adjusted net capital, approximately \$550 million of customer assets in segregation, and approximately \$60 million in separate Section 30.7 accounts.

C. Facts

On April 8, 2013, MSSB had a secured funds requirement of \$67.8 million. However, that day MSSB erroneously transferred approximately \$16 million in foreign exchange funds from a customer secured funds bank account to a customer segregated funds brokerage account, instead of an intended customer secured brokerage account, resulting in a deficiency in MSSB's secured amount of approximately \$9.27 million. MSSB discovered that it was under-secured on April 9, 2013, moved to cure the deficiency that day, and promptly filed written notice with the National Futures Association ("NFA") and Commission indicating that adequate funds were not maintained to meet the firm's foreign futures and options secured amount requirement.

Other failures further demonstrate MSSB's lack of adequate internal controls, procedures, and supervision. For example, in connection with a transfer of securities collateral, MSSB took funds into a customer segregated account, even though some of the collateral should have been in a non-customer account; as a result, from at least July 2012 to November 2012, MSSB commingled more than \$1 million of employee owned non-customer securities with approximately \$43 million in customer securities in a customer segregated account. From at least September to at least October 2012, account statements for four MSSB segregated accounts at a bank were improperly titled as customer secured accounts by the bank, although the required acknowledgment letters properly identified the accounts as customer segregated.

MSSB also failed to implement adequate procedures to comply with Commission requirements for computing segregated and secured funds. From at least May 2012 until January 2013, MSSB failed to properly compute its secured funds on deposit at the close of each business day. Specifically, MSSB neglected to include open trade equity on certain London Metals

Exchange contracts in preparing its daily statements. Additionally, from at least July 2012 to December 2012, MSSB failed to properly compute its segregated funds on deposit due to incorrect valuation of a Treasury bill in a customer's account and certain treasury inflation protected securities ("TIPS"). These valuation errors resulted in at least 32 customers receiving account statements that misstated the collateral value held in their accounts. MSSB was unaware of its computation errors and incorrect account statements until the NFA or MSSB's customers identified the problems. Ultimately, the NFA required MSSB to re-file 120 daily statements as a result of the errors.

None of these errors caused MSSB to fall below its segregated funds or secured amount requirements. However, the errors reveal a lack of adequate internal controls and a failure to diligently supervise the handling of MSSB's business as a Commission registrant.

After its secured deficiency in April 2013, MSSB independently engaged KPMG LLP to review its policies and procedures with respect to segregated and secured accounts. KPMG subsequently issued a report recommending changes to MSSB's policies and procedures, which MSSB has substantially implemented.

D. Legal Discussion

1. Secured Deficiency

Regulation 30.7(a), 17 C.F.R. § 30.7(a) (2013), prohibits an FCM from commingling secured funds with its own funds or the funds of any other person, and provides that an FCM "must maintain in a separate account or accounts, money, securities and property in an amount at least sufficient to cover or satisfy all of its current obligations to foreign futures or foreign options customers denominated as the foreign futures or foreign options secured amount." The Regulations also prohibit commingling secured funds with customer funds regulated under Section 4d(a)(2) of the Act and Regulations thereunder. *See* Regulation 30.7(d), 17 C.F.R. § 30.7(d) (2013).

MSSB violated Regulation 30.7(a) by transferring funds from a secured funds bank account to a segregated funds brokerage account and consequently failing to maintain in a separate account money, securities and property in an amount sufficient to cover \$9.27 million of its obligations to foreign futures and options customers from April 8, 2013 to April 9, 2013.

2. Failure to Properly Segregate Customer Funds

Section 4d(a)(2) of the Act, 7 U.S.C. § 6d(a)(2) (2012), requires that, among other things, customer funds "shall be separately accounted for and shall not be commingled" with an FCM's funds. Regulation 1.20(c), 17 C.F.R. § 1.20(c) (2013), sets forth the requirements for customer funds traded on domestic exchanges, including the requirement prohibiting an FCM from commingling segregated funds with its own funds or the funds of any other person. Regulation 1.20(a) requires that customer segregated funds be separately accounted for and segregated as belonging to commodity or option customers and be deposited under an account name that

clearly identifies them as such and shows that they are segregated as required by the Act and Regulations.

From at least July 2012 to November 2012, MSSB comingled approximately more than \$1 million in employee-owned non-customer securities with approximately \$43.4 million in customer securities in a customer segregated account in violation of Section 4d(a)(2) of the Act and Regulation 1.20(c).

Finally, from at least September to at least October 2012, account statements for four MSSB segregated accounts were improperly titled as customer secured accounts in violation of Regulation 1.20(a).

3. Failure to Prepare Accurate Daily Computations and Customer Account Statements

Regulation 30.7(f) requires FCMs to compute on a daily basis the “total amount of money, securities and property” on deposit in separate accounts held for foreign futures or foreign options customers. 17 C.F.R. § 30.7(f) (2013).

Similarly, Regulation 1.32(a), 17 C.F.R. § 1.32(a) (2013), requires FCMs to compute on a daily basis the “total amount of customer funds on deposit in segregated accounts on behalf of commodity and option customers” and the amount of such funds required by the Act and regulations to be on deposit in segregated accounts on behalf of such commodity and option customers on a currency-by-currency basis.

Regulation 1.33 requires FCMs to provide commodity, options, foreign futures, and foreign options customers monthly statements showing, among other things, “[a]ny related customer funds carried in such customer’s account(s) or any related foreign futures or foreign options secured amount carried in the account(s) of a foreign futures or foreign options customer.”

From at least May 2012 to January 2013, MSSB violated Regulation 30.7(f) by failing to prepare accurate daily computations of its secured amounts. MSSB also violated Regulation 1.32(a) by failing to prepare accurate daily computations of its segregated funds from at least July 2012 to December 2012. MSSB further violated Regulation 1.33 by providing at least 32 customers with inaccurate account statements from at least July 2012 to December 2012.

4. Failure to Supervise

Regulation 166.3, 17 C.F.R. § 166.3 (2013), requires that each Commission registrant, except an associated person who has no supervisory duties, diligently supervise the handling by its partners, officers, employees and agents (or other persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees, and agents

(or other persons occupying a similar status or performing a similar function) relating to its business as a registrant. Risk management activity, which exists in principal part to ensure a firm's continued financial viability, and, derivatively, to ensure that customers are protected, constitutes other activities relating to a firm's business as a Commission registrant which must be diligently supervised. A violation under Regulation 166.3 is an independent violation for which no underlying violation is necessary. See *In re Collins*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,194 at 45,744 (CFTC Dec. 10, 1997).

A violation of Regulation 166.3 is demonstrated by showing either that: (1) the registrant's supervisory system was generally inadequate; or (2) the registrant failed to perform its supervisory duties diligently. *In re Murlas Commodities*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,485 at 43,161 (CFTC Sept. 1, 1995); *In re GNP Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 at 39,219 (CFTC Aug. 11, 1992)(providing that, even if an adequate supervisory system is in place, Regulation 166.3 can still be violated if the supervisory system is not diligently administered), *aff'd sub nom. Monieson v. CFTC*, 996 F.2d 852 (7th Cir. 1993); *In re Paragon Futures Ass'n*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,266 at 38,850 (CFTC Apr. 1, 1992) ("The focus of any proceeding to determine whether Rule 166.3 has been violated will be on whether [a] review [has] occurred and, if it did, whether it was diligent"). Evidence of violations that "should be detected by a diligent system of supervision, either because of the nature of the violations or because the violations have occurred repeatedly" is probative of a failure to supervise. *In re Paragon Futures*, ¶ 25,266 at 38,850.

From at least February 2012 to at least April 2013, MSSB failed to put into place procedures reasonably designed to (i) prevent a secured deficiency; (ii) ensure that only customer funds remained in customer accounts; (iii) ensure that segregated fund bank accounts were properly titled; (iv) ensure the accuracy of its daily computations for its customer funds, and the accuracy of its monthly 1-FRs; and (v) ensure that its customers received accurate account statements. MSSB further failed to adequately and diligently supervise its employees, officers, and agents to ensure compliance with the Act and Regulations, including with respect to handling, monitoring, and preparing computations and statements related to customer funds. MSSB thereby failed to supervise diligently the activities of its employees relating to its business as a Commission registrant by not having sufficient policies and procedures in place to detect and deter the violations of the Regulations found herein, in violation of Regulation 166.3.

IV.

FINDINGS OF VIOLATIONS

Based on the foregoing, the Commission finds that MSSB violated Section 4d(a)(2) of the Act, 7 U.S.C. § 6d(a)(2) (2012) and Commission Regulations 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3, 17 C.F.R. §§ 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3 (2013).

V.

OFFER OF SETTLEMENT

MSSB has submitted an Offer of Settlement in which it, without admitting or denying the findings and conclusions herein:

- A. Acknowledges receipt of service of the Order;
- B. Admits the jurisdiction of the Commission with respect to all matters set forth in the Order and for any action or proceeding brought or authorized by the Commission based on violation of or enforcement of the Order;
- C. Waives:
 - 1. the filing and service of a complaint and notice of hearing;
 - 2. a hearing;
 - 3. all post-hearing procedures;
 - 4. judicial review by any court;
 - 5. any and all objections to the participation by any member of the Commission's staff in the Commission's consideration of this Offer;
 - 6. any and all claims that it may possess under the Equal Access to Justice Act, 5 U.S.C. § 504 (2012) and 28 U.S.C. § 2412 (2012), and/or the rules promulgated by the Commission in conformity therewith, Part 148 of the Commission's Regulations, 17 C.F.R. §§ 148.1-30 (2013), relating to, or arising from, this proceeding;
 - 7. any and all claims that it may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, §§ 201-253, 110 Stat. 847, 857-868 (1996), as amended by Pub. L. No. 110-28, § 8302, 121 Stat. 112, 204-205 (2007), relating to, or arising from, this proceeding; and
 - 8. any claims of Double Jeopardy based on the institution of this proceeding or the entry in this proceeding of any order imposing a civil monetary penalty or any other relief;

- D. Stipulates that the record basis on which the Order is entered shall consist solely of the findings contained in the Order to which MSSB has consented in this Offer; and
- E. Consents, solely on the basis of this Offer, to the Commission's entry of the Order in the form attached hereto that:
1. Makes findings by the Commission that MSSB has violated Section 4d(a)(2) of the Act, 7 U.S.C. § 6d(a)(2) (2012), and Regulations 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3, 17 C.F.R §§ 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3 (2013);
 2. Orders MSSB to cease and desist from violating Section 4d(a)(2) of the Act, 7 U.S.C. § 6d(a)(2) (2012), and Regulations 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3, 17 C.F.R §§ 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3 (2013);
 3. Orders MSSB to pay a civil monetary penalty in the amount of four hundred ninety thousand dollars (\$490,000) (the "CMP Obligation") plus post-judgment interest; and
 4. Orders MSSB and its successors and assigns to comply with the undertakings consented to in its Offer and as set forth below in Section VI of this Order.

Upon consideration, the Commission has determined to accept MSSB's Offer.

VI.

ORDER

Accordingly, IT IS HEREBY ORDERED THAT:

- A. MSSB shall cease and desist from violating Section 4d(a)(2) of the Act, 7 U.S.C. § 6d(a)(2) (2012), and Regulations 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3, 17 C.F.R §§ 1.20(a), (c); 1.32(a); 1.33; 30.7(a), (f); and 166.3 (2013);
- B. MSSB shall pay a civil monetary penalty in the amount of four hundred ninety thousand dollars (\$490,000) (the "CMP Obligation") within ten (10) days of the date of entry of this Order. If the CMP Obligation is not paid in full within ten (10) days of the date of entry of this Order, then post-judgment interest shall accrue on the CMP Obligation beginning on the date of entry of this Order and shall be determined by using the Treasury Bill rate prevailing on the date of entry of this Order pursuant to 28 U.S.C. § 1961 (2006). MSSB shall pay the CMP Obligation by electronic funds transfer, U.S. postal money order, certified check,

bank cashier's check, or bank money order. If payment is to be made other than by electronic funds transfer, then the payment shall be made payable to the Commodity Futures Trading Commission and sent to the address below:

Commodity Futures Trading Commission
Division of Enforcement
ATTN: Accounts Receivables --- AMZ 340
E-mail Box: 9-AMC-AMZ-AR-CFTC
DOT/FAA/MMAC
6500 S. MacArthur Blvd.
Oklahoma City, OK 73169
Telephone: (405) 954-5644

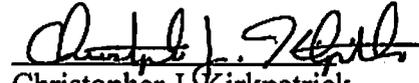
If payment is to be made by electronic funds transfer, MSSB shall contact Nikki Gibson or her successor at the above address to receive payment instructions and shall fully comply with those instructions. MSSB shall accompany payment of the CMP Obligation with a cover letter that identifies it and the name and docket number of this proceeding. MSSB shall simultaneously transmit copies of the cover letter and the form of payment to the Chief Financial Officer, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581; and

- C. MSSB and its successors and assigns shall comply with the following undertaking set forth in its Offer:
1. MSSB agrees that neither it nor any of its agents or employees under its authority or control shall take any action or make any public statement denying, directly or indirectly, any findings or conclusions in the Order or creating, or tending to create, the impression that the Order is without a factual basis; provided, however, that nothing in this provision shall affect MSSB's: (i) testimonial obligations; or (ii) right to take legal positions in other proceedings to which the Commission is not a party. MSSB and its successors and assigns shall undertake all steps necessary to ensure that all of its agents and/or employees under its authority or control understand and comply with this agreement.
 2. Partial Satisfaction: MSSB understands and agrees that any acceptance by the Commission of partial payment of MSSB's CMP Obligation shall not be deemed a waiver of its obligation to make further payments pursuant to this Order, or a waiver of the Commission's right to seek to compel payment of any remaining balance.
 3. Change of Address/Phone: Until such time as MSSB satisfies in full its CMP Obligation as set forth in this Consent Order, MSSB shall provide written notice to the Commission by certified mail of any change to its

telephone number and mailing address within ten (10) calendar days of the change.

The provisions of this Order shall be effective on this date.

By the Commission



Christopher J. Kirkpatrick
Deputy Secretary of the Commission
Commodity Futures Trading Commission

Dated: March 27, 2014